DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 07-0069
Sales and Use Tax
For the Year 2005

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ISSUES

I. **Sales and Use Tax –** Imposition on Aircraft Purchase.

Authority: IC § 6-8.1-5-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-8; IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-2.5-4-10; 45 IAC 2.2-3-4; 45 IAC 2.2-5-15; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,* 867 N.E.2d 289 (Ind. Tax. Ct. 2007); *Indiana Dept. of Revenue v. Interstate Warehousing,* 783 N.E.2d 248 (Ind. 2003).

Taxpayer protests denial of rental exemption and subsequent imposition of use tax on the purchase of an aircraft.

II. **Tax Administration –** Imposition of Negligence Penalty.

Authority: IC § 6-8.1-10-2.1, 45 IAC 15-11-2.

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana single-member LLC, is the purchaser and registered owner of an aircraft. Taxpayer is a qualified subsidiary of an Indiana S-Corporation (Holding Company). Taxpayer purchased the aircraft in early November 2005 for $342,000. Taxpayer did not pay sales tax on the purchase, claiming an exemption for rental or lease to others. The Indiana Department of Revenue ("Department") reviewed the claim for exemption and determined that taxpayer did not qualify for the exemption. On December 4, 2006, the Department denied the exemption and issued a proposed assessment for use tax, interest and penalty on use of the aircraft in Indiana. Taxpayer paid the proposed assessment on January 5, 2007, but protests the assessment and the associated negligence penalty.

Taxpayer leased the aircraft to its one-hundred percent owner, Holding Company, and to another affiliated entity (Company B). Taxpayer's principal, is also the principal of each of the two related companies with which Taxpayer has rental agreements. Taxpayer has remitted sales tax on the rental of the aircraft.

Per a March 5, 2007, letter from Taxpayer to the Department, the aircraft was damaged beyond repair in an in-flight incident on September 15, 2006. Per same letter, Taxpayer states that it received payment of $342,000 from its insurance company which then sold the airplane for $112,400.

A telephone hearing was held where Taxpayer's principal and its representative were present. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition on Aircraft Purchase.

DISCUSSION

All tax assessments are presumed to be accurate. The taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind.Tax Ct. 2007).

Indiana imposes a use tax on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2; 45 IAC 2.2-3-4. IC § 6-2.5-3-4(a)(2) allows for a use tax exemption for property that is acquired in a transaction that is exempt from sales tax under IC § 6-2.5-5, and the property is being stored, used, or consumed for the purpose for which it was exempted. One of those exemptions is found at IC § 6-2.5-5-8(b) which states that,

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property.

The rental exemption set out in IC § 6-2.5-5-8 is further explained in 45 IAC 2.2-5-15, which states:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.
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> (b) General rule. Sales of tangible personal property for resale, renting or leasing are exempt from tax if all of the following conditions are satisfied:
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> > (1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;
> > (2) The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business; and
> > (3) The property is resold, rented or leased in the same form in which it was purchased.

When a taxpayer claims it is entitled to a tax exemption, it bears the burden of proving that the terms of the exemption have been met. *Indiana Dep't. of Revenue v. Interstate Warehousing*, 783 N.E.2d 248, 250 (Ind. 2003). The Department will strictly construe the exemption statutes against the taxpayer claiming the exemption. *Id*.

Taxpayer argues that the Indiana Code provides clearly for this exemption. Taxpayer states that it has lease agreements with two entities which therefore represent its retail rental transactions and therefore the aircraft is not subject to the sales tax. Taxpayer supports its argument by citing to IC § 6-2.5-4-10(a), which states.

> A person, other than a public utility, is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person other than for subrent or sublease.

However, IC § 6-2.5-4-1 offers the backdrop to the statute Taxpayer cites by setting out what "selling at retail" means. IC § 6-2.5-4-1 states in part:

> (a) A person is a retail merchant making a retail transaction when he engages in selling at retail.
> (b) *A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business*, he:
> (1) acquires tangible personal property for the purpose of resale; and
> (2) transfers that property to another person for consideration.
> (c) For purposes of determining what constitutes selling at retail, it does not matter whether:
> (1) the property is transferred in the same form as when it was acquired;
> (2) the property is transferred alone or in conjunction with other property or services; or
> (3) the property is transferred conditionally or otherwise.

The above exemption, therefore, requires compliance with three elements. One of these requirements is that the Taxpayer must be occupationally engaged in the reselling, renting, or leasing of such property in its regular course of business. To be occupationally engaged in an activity means that the activity is a regular activity of its principal business.

The determination as to whether a Taxpayer meets this requirement is based on a number of indicia that generally address, on a fact-sensitive basis, whether Taxpayer is occupationally engaged in the business of leasing or renting aircraft.

In making this determination, the terms of Taxpayer's aircraft lease agreements are considered. Taxpayer has lease agreements with an affiliated entity (Company B), and with Holding Company. Both Taxpayer and Company B are one-hundred (100) percent owned by Holding Company. Per the terms of the agreements, lessees are responsible for insurance, hangar fees, maintenance and fuel expenses. Taxpayer charges two-hundred dollars an hour on a dry lease. All entities were covered under the same insurance policy with the lessees listed as additionally insured. The general terms of the agreements appear generally to be at arms-length. However,

according to the terms of the lease agreements, sales are "calculated on an annual basis ending each October 31st." This approach appears uncharacteristic of a retail merchant occupationally engaged in retail transactions in the ordinary course if its regularly conducted business as defined by IC § 6-2.5-4-1.

At the request of the Department, Taxpayer provided a flight log for the period from November 3, 2005 through September 15, 2006, at which time the aircraft was disabled. According to the flight log, over the ten and a half months Taxpayer's aircraft was in operation, the aircraft was leased for a total of seventy-two hours. For five of those months, the aircraft was leased for five or, more often, less hours. The rest of the time, the aircraft was leased for an average of twelve hours a month. Sales for 2006 totaled $14,400.

The Indiana legislature had added language to IC § 6-2.5-5-8 that serves as a useful guide for what is leasing an aircraft "in the normal course of business."

IC § 6-2.5-5-8(e) states:

> (e) This subsection applies only after June 30, 2008. A transaction in which a person acquires an aircraft for rental or leasing in the ordinary course of the person's business is not exempt from the state gross retail tax unless the person establishes, under guidelines adopted by the department in the manner provided in IC 4-22-2-37.1 for the adoption of emergency rules, that the annual amount of the lease revenue derived from leasing the aircraft is equal to or greater than:
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> (1) ten percent (10[percent]) of the greater of the original cost or the book value of the aircraft, if the original cost of the aircraft was less than one million dollars ($1,000,000); or
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> (2) seven and five-tenths percent (7.5[percent]) of the greater of the original cost or the book value of the aircraft, if the original cost of the aircraft was at least one million dollars ($1,000,000).

As this subsection plainly states, it will only apply after June 30, 2008. However, while not controlling for an aircraft purchased in 2005, it is a useful guide in the instant case. Here, the aircraft in question was purchased for just over $340,000. As provided by IC § 6-2.5-5-8(e)(1), after June 30, 2008, the annual amount of lease revenue derived from the leasing of the aircraft would need to be equal or greater than ten percent of the greater of the original cost or the book value of the aircraft in order for Taxpayer to qualify for the exemption; i.e., a minimum of thirty-four thousand dollars ($34,000).

A review of the Department's sales tax records shows that Taxpayer did remit sales tax on most of the revenue it collected in late 2005 and 2006. Taxpayer purchased the aircraft in early November 2005 and reported sales in the last quarter of 2005 of $2,000 and remitted sales tax on that amount. For 2006, Taxpayer reported a total of $13,320 in sales and remitted sales tax on that amount. However, Taxpayer did not report sales in the first quarter or the last quarter of 2006. The accident referenced above occurred on September 15, 2006, thus explaining why no sales were reported in the last quarter. Taxpayer's flight log suggests that Taxpayer should have reported approximately $2,000 in sales in the first quarter of 2006 (ten hours of flight time,

multiplied by the rental rate of $200/hr.). Even if that amount is added to Taxpayer's reported 2006 sales, its rental stream for 2006 is less than five percent of the purchase price of the aircraft, well below the ten percent requirement that goes into effect on June 30, 2008. Assuming, for the sake of argument, that the aircraft was not disabled in the last quarter of 2006 and an average of the prior three quarters (including sales not reported in the first quarter of 2006) is projected for the last quarter of 2006, sales would still have been less than seven percent, again well below the ten percent requirement that goes into effect on June 30, 2008.

When taken into account with the other documentation Taxpayer has provided, Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c). It is noted that Taxpayer remitted sales tax to the Department on its rental stream of income on behalf of its lessees. The lessees may claim for refund of these remitted taxes.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as
> negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has gone a long way in documenting its business transactions in order to support its claims. While Taxpayer's application for the aircraft lease exemption is denied, the Department recognizes that Taxpayer has nonetheless promptly acted, within its understanding, to collect sales tax on its transactions. Additionally, Taxpayer has maintained its business records in model fashion.

FINDING

Taxpayer's protest is sustained.

LS/WL/DK – November 13, 2007